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In The Supreme Court of The United States

OCTOBER TERM, 1964

No. 559

EDWARD C. JOHNSON 2D, ET AL.,
Petitioners

v.

S. HAROLD LEVITT, EXECUTOR,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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S. HAROLD LEVITT, EXECUTOR,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the First Circuit entered in the above entitled case on July 8, 1964.

OPINIONS BELOW

The Opinion of the District Court is reported at 222 F. Supp. 805, and is reprinted as Appendix "A" to this petition. The Opinion of the Court of Appeals is reported at 334 F. 2d 815 and is reprinted as Appendix "B" to this petition.

JURISDICTION

The judgment of the Court of Appeals was entered on July 8, 1964.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Does the assertion by a minority stockholder of an implied federal cause of action under the Investment Company Act of 1940 on behalf of his corporation give the minority stockholder the right to act as the corporation's representative in pursuing that claim even though he has not satisfied the requirements of the law of the state of incorporation with respect to making prior application to his fellow shareholders?

2. If the law of the state of incorporation does not govern, should the complaining minority stockholder be excused from making prior demand upon his fellow stockholders as a matter of federal law when the transactions sought to be set aside in the derivative action as in violation of the Investment Company Act of 1940 have been previously approved by the shareholders in accordance with the Act?

3. Does Section 37 of the Investment Company Act of 1940, 15 U.S.C. § 80a-36, condemn, as criminal larceny, embezzlement or willful conversion, the open payment or receipt of compensation pursuant to a contract specifically authorized by the Act and admittedly disclosed to and ratified and approved by the shareholders of the investment company in the manner called for by the Act?

4. Does the Securities and Exchange Commission have primary jurisdiction to overturn the presumption established by Section 2(a)(9) of the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(9), that a natural person shall be presumed not to be a controlled person within the meaning of the Act until a determination to the contrary is made by the Commission?

STATUTES INVOLVED

The pertinent provisions of Sections 2, 10, 37 and 47 of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-2, 80a-10, 80a-36 and 80a-46, are set forth as Appendix "C" to this petition.

STATEMENT

This is a stockholder's derivative action brought by Respondent, the executor of a deceased stockholder of Fidelity Capital Fund, Inc. (the "Fund"), against the Fund, individuals now or formerly directors of the Fund, the Fund's investment adviser and principal underwriter and another investment company. Respondent seeks an accounting and recovery of money damages for alleged violations of the Investment Company Act of 1940, 15 U.S.C. §80a-1 *et seq.*, hereinafter sometimes referred to as the Act.

The allegations of the Complaint relate primarily to advisory fees paid by the Fund to the defendant Fidelity Management & Research Company pursuant to an Advisory and Service Contract (the "Contract") made on January 28, 1958, amended March 12, 1958, and, as the Complaint admits, "approved by the stockholders on March 15, 1961" (R. 4). The Contract was ratified and its continuance approved by the stockholders again on March 13, 1962 and March 28, 1963 (R. 43, 44).

The Complaint alleges that the advisory fees are "grossly excessive, unreasonable and illegal" and that their payment constitutes a violation of Section 37 of the Act, 15 U.S.C. § 80a-36. The Complaint further alleges that the defendant Johnson "controls" the other directors of the Fund, that a majority of the Fund's directors are therefore persons "affiliated" (within the meaning of Section 2(a)(3)(C) of the Act, 15 U.S.C. § 80a-2(a)(3)(C)) with the Fund's investment adviser, also controlled by Johnson, that Section 10(a) of the Act, 15 U.S.C. § 80a-10(a) makes such affiliation illegal,

and as a consequence the Contract with the adviser is null and void under Section 47(b) of the Act, 15 U.S.C. § 80a-46(b). The Complaint also alleges that since Section 10(b)(2), 15 U.S.C. § 80a-10(b)(2) makes a similar affiliation with the Fund's underwriter illegal, the underwriting agreement between the Fund and The Crosby Corporation is likewise null and void.

The Complaint also charged originally that the conduct described constituted mismanagement and waste of corporate assets in violation of Massachusetts law, but these pendent claims were dismissed, and Respondent conceded in the Court of Appeals the propriety of the dismissal of these claims by the District Court.

Petitioners moved to dismiss the Complaint on the grounds that the District Court lacked jurisdiction of the subject matter, that the complaint did not comply with the requirements of Rule 23 (b), Fed. R. Civ. P., and that the Complaint failed to state a claim upon which relief could be granted. Prior to the hearing on the motions to dismiss, Petitioners filed an affidavit of the clerk of the Fund, presenting matters outside the pleadings (R. 35). The affidavit related *inter alia* to the several shareholder votes ratifying and approving the challenged Contract, to the vote by Respondent's decedent ratifying and approving the Contract, and to the disclosure of relevant facts by the Fund to its shareholders prior to each of these shareholder votes.

The District Court did not exclude any of the matters outside the pleadings thus presented by Petitioners and, in accordance with Rule 12(b), Fed. R. Civ. P., treated Petitioners' motions to dismiss as motions for summary judgment. The District Court dismissed the Complaint on the ground that Respondent failed to comply with the law of the state of incorporation since he did not allege that he had made prior demand upon his fellow shareholders and his alleged excuses for failure to do so were insufficient.

From such dismissal by the District Court, Respondent appealed to the United States Court of Appeals for the First Circuit. Petitioners argued in the Court of Appeals that the dismissal of the Complaint should be affirmed, *first*, because the Complaint did not satisfy the requirements of prior demand established by the law of the Fund's state of incorporation, and *second*, because the Complaint did not satisfy the requirements of prior demand should federal law be held applicable.

Petitioners also argued before the Court of Appeals that the dismissal of the Complaint should be affirmed on the additional grounds (1) that the several shareholder votes ratifying and approving the challenged contract barred Respondent's suit, (2) that the vote by Respondent's decedent ratifying and approving the challenged contract barred Respondent's suit, and (3) that the Complaint failed to allege any claim for relief under the Investment Company Act of 1940 because the Act does not proscribe the conduct set out in Respondent's Complaint and because the Securities and Exchange Commission has primary jurisdiction as to some of the essential matters raised by the Complaint. The District Court had not reached these additional grounds.

The Court of Appeals declined to pass upon any of these additional grounds "not considered below, absent a clear showing of its inescapable correctness." (*infra*, p. 33). The Court of Appeals vacated the judgment of the District Court, and in doing so held that under federal law Respondent was excused from making prior demand upon his fellow shareholders and that if the law of the state of incorporation differed from federal law in this regard, the Act forbade the application of state law to Respondent's derivative claim.

REASONS FOR GRANTING THE WRIT

1. In failing to apply the law of the state of incorporation with respect to the adequacy of Respondent's excuses for his failure to make prior demand upon his fellow shareholders before bringing his derivative action, the Court of Appeals has decided an important federal question in a manner not in conformity with decisions of this Court.

The Investment Company Act of 1940 does not expressly provide for derivative suits by stockholders of registered investment companies. Congress has been completely silent as to who, if anybody, may bring such a suit under the Act and under what circumstances. Since Congress accepted and left intact the existing industry structure and relationships and did not require the federal incorporation of investment companies, Congress clearly accepted, as still governing many aspects of the industry, the laws of the states of incorporation of investment companies. Difficult and important questions are presented here involving the interplay of state and federal law.

The conventional rule is that the law of the state of incorporation determines the right of a shareholder to participate in the administration of the corporation's affairs and to act as its representative in pursuing a claim. See Restatement (Second), Conflict of Laws (Tentative Draft No. 7, April 18, 1962) § 183; Restatement (First), Conflict of Laws § 183; Reese and Kaufman, *The Law Governing Corporate Affairs*, 58 Col. L.Rev. 1118, 1125, 1127 (1958).

Such a rule follows from the often recognized plenary regulatory power which a state necessarily must have over the internal relations between a corporation created pursuant to its laws and the corporation's stockholders. This Court has clearly recognized that power in *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541 at 549, 550:

> "The very nature of a stockholders' derivative action makes it one in the regulation of which the legislature of

a state has wide powers. Whatever theory one may hold as to the nature of the corporate entity, *it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon a state law and may be subject to most complete and penetrating regulation,* either by public authority or by some form of stockholder action. . . .

". . . *We conclude that the state has plenary power over this type of litigation.*" (Emphasis supplied.)

The assertion of a derivative claim based upon a federal statute does not justify ignoring state law as to those aspects of the shareholder's rights which are not spelled out in the federal statute creating the right sought to be asserted. Thus, in *Price* v. *Gurney,* 324 U.S. 100, this Court applied the law of the state of incorporation in determining whether a stockholder had standing in a federal court to enforce either his own or his corporation's rights expressly conferred by federal statute:

". . . In absence of federal incorporation, intracorporate disputes of the character presented here are, as we have said, governed by state law." 324 U.S. at 107.

Justice Brandeis was following the same principle in *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 264, when he stated on behalf of the Court that "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual stockholders the right to interfere with the internal management of the corporation."

Despite the fact that the Act refrains from injecting federal regulation into matters involving the internal self-government of investment companies, and despite decisions of this Court that such matters are to be left to be governed by the law of the state of incorporation, the Court of

Appeals swept aside the state law as in conflict with the preamble of the Act (Section 1(b), 15 U.S.C. § 80a-1(b)) which declares that the Act shall be interpreted "so far as is feasible to eliminate conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

Preambles do not make the law. Nor are they mandates to federal courts to fashion rules of law without regard to the sections which follow. Were it otherwise, no sections beyond the preamble would ever be required and every case could be decided on an *ad hoc* basis, resting firmly on a broad statement of policy contained in the preamble.

The Act is a carefully framed regulatory statute in which Congress has precisely stated the means by which its declaration of policy is to be executed. The Act evinces no intention on the part of Congress to change general rules relating to derivative actions or to regulate the aspect of internal self-government here involved.

To the extent that any Congressional view can be deduced from the Act, it may be said that Section 15, 15 U.S.C. § 80a-15, requiring that selection of the investment adviser, the most important action to be taken by an investment company, be "approved by the vote of a majority of the outstanding voting securities", shows a desire to ensure that matters concerning the adviser be thoroughly considered by the stockholders as a whole and be an expression of their majority will. To the same effect are other provisions of the Act relating to both the continuance and the termination of the advisory contract, Sections 15(a)(2) and (3), 15 U.S.C. §§ 80a-15(a)(2) and (3). This concept that a majority of the shareholders should be free to decide major issues runs throughout the Act. Under Section 13(a), 15 U.S.C. § 80a-13(a), only the shareholders can authorize a change in the classification of an investment company, or authorize changes in certain of the company's policies, or

authorize certain changes in the nature of the company's business.

The Court of Appeals apparently concluded not only that Congress was wrong in placing in the hands of the shareholders the ultimate power to decide major issues affecting the company, but also that Congress intended to sweep aside rules of law which are founded on that very principle.

Reliance by the Court of Appeals on the recent decision of this Court in *J. I. Case Co.* v. *Borak*,—U.S.—(June 8, 1964) was misplaced. The question before the Court in that case was whether the federal courts should fashion private remedies for violations of a federal statute or limit their jurisdiction to the granting of declaratory relief, remitting injured parties to state courts for remedial relief. This Court held that it was the duty of the federal courts to provide such remedies where federally secured rights are invaded. In the present case the Respondent seeks to assert derivatively a federal cause of action on behalf of his corporation. The scope of that right and the remedies to be afforded are, as *J. I. Case* v. *Borak, supra,* holds, governed by federal law. But in the absence of federal incorporation and in the absence of a federal statute giving a shareholder a direct right to assert a claim on behalf of his corporation (Cf. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b)), it does not follow that federal law must also govern the intracorporate procedures for determining what is to be done about that right or who is to assert it.

Under Massachusetts law it is a prerequisite that a stockholder, before bringing a derivative suit, show that he has resorted to the body of shareholders except in the one instance where he shows that the majority of the voting stock is under the control of the alleged wrongdoers. *Datz* v. *Keller,* Mass. Adv. Sh. 491, 196 N.E. 2d 922 (1964); *S. Solomont & Sons Trust Inc.* v. *New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E. 2d 241 (1950); *Bart-*

lett v. *New York, N.H. & H. R.R.*, 221 Mass. 530, 109 N.E. 452 (1915). See *Halprin* v. *Babbitt*, 303 F. 2d 138 (1st Cir. 1962); *Carroll* v. *New York, N.H. & H. R.R.*, 141 F.Supp. 456 (D. Mass. 1956); and *Pomerantz* v. *Clark*, 101 F.Supp. 341 (D. Mass. 1951). The suggestion by the Court of Appeals that Massachusetts law might be otherwise cannot be sustained and is completely inconsistent with the most recent decision of the Massachusetts Supreme Judicial Court in *Datz* v. *Keller, supra,* and the decision in *Bartlett* v. *New York, N.H. & H. R.R., supra,* neither of which is referred to by the Court of Appeals.

The law of Massachusetts with respect to the requirement of prior demand depends in part upon the Massachusetts view of the power possessed by a disinterested majority of stockholders acting in good faith to decide that, in their judgment, it is not in the best interests of the corporation to assert a claim on its behalf. In addition the requirement of prior demand serves to give the majority stockholders an opportunity to take some action themselves. Both principles are entirely consistent with, and in furtherance of, the policies of the Act.

The questions whether the present action should be brought and who should bring it are preeminently for the consideration of the shareholders since the shareholders of the Fund have, as required by the Act, already approved the basic elements of the transactions sought to be undone by the Respondent. Cf. *Heinz* v. *National Bank of Commerce*, 237 Fed. 942 (8th Cir. 1916). In the present case the holder of three one-millionths of the outstanding shares seeks to set aside the Contract which the shareholders of the Fund ratified and approved by overwhelming votes each time it was submitted to them, namely, three times in the two and one-half year period immediately preceding the filing of Respondent's suit (R. 41, 42 and 44).

The Complaint contains no allegation that the Contract was not properly approved by the shareholders on each of these occasions. On the contrary, the Complaint admits that the shareholders approved the Contract on March 15, 1961 (R. 4); and Petitioners' undisputed affidavit shows the other approvals in 1962 and 1963 and the extent of the disclosures made to shareholders prior to all three approvals.

Where the shareholders of an investment company have, as Congress intended, approved the terms of the Contract on three separate occasions in the last three years and with almost no stockholder dissent, it can hardly be considered inconsistent with the Act which specifies such shareholder approval to require that Respondent, the executor of a deceased stockholder owning less than three one-millionths of the outstanding shares of the Fund, to make prior application to his fellow shareholders before plunging his corporation into litigation seeking to set aside the Contract. The Court of Appeals erred in failing to apply Massachusetts law which would require such prior application.

2. In holding that as a matter of federal law prior demand by a minority stockholder upon his fellow shareholders should be excused where the number of shareholders is large, the decision below is at variance with *Haffer* v. *Voit,* 219 F.2d 704 (6th Cir. 1955), *cert. denied sub nom. Ames* v. *Mengel Co.,* 350 U.S. 832 and also represents a decision on an important question of federal law which has not been, but should be, settled by this Court.

In *Haffer* v. *Voit, supra,* the Court of Appeals for the Sixth Circuit affirmed the dismissal of a minority stockholder's derivative claim for his failure to make prior demand where it appeared (a) that the challenged revision of a stock option had been disclosed to stockholders in the company's proxy material, (b) that the revised stock option was subject to being altered or repealed by the stockholders, (c) that the stockholders had not taken any such action to

alter or repeal it and (d) that the plaintiffs failed to make any effort to obtain from the stockholders such action as they desired. The Court of Appeals held legally insufficient the plaintiffs' explanation that they had made no effort to secure such action from stockholders because, among other things, they were widely scattered and there would be expense and delay incident to such demand. Other federal court decisions are to the same effect. *Levitan* v. *Stout,* 97 F. Supp. 105 (W.D. Ky. 1951); *Varanelli* v. *Wood,* 9 F.R.D. 61 (S.D.N.Y. 1949); *Bruce & Co.* v. *Bothwell,* 8 F.R.D. 45 (S.D.N.Y. 1948).

The present case is an even stronger one for rejecting this excuse than *Haffer* v. *Voit, supra.* Here the terms of the challenged Contract were not only disclosed to shareholders but specifically ratified and approved by them on several occasions. Furthermore, the Contract is, as required by the Act (Section 15(a)(3), 15 U.S.C. § 80a-15(a)(3)), subject to termination without penalty by vote of the shareholders. The decision of the Court of Appeals for the First Circuit in the present case cannot be reconciled with the decision of the Court of Appeals for the Sixth Circuit in *Haffer* v. *Voit, supra.*

3. The present case presents substantial questions of federal law concerning the Investment Company Act of 1940 which have not been, but should be, settled by this Court, namely, whether a private right of action is to be inferred under the Act, what the scope of such an action should be if it is inferred, and whether the Securities and Exchange Commission has primary jurisdiction with respect to that portion of Respondent's claim which rests upon a finding that certain of the individual petitioners are controlled persons.

Not only is the first question referred to above, whether or not to infer any private right of action under the Act, one which is of great public importance in the future admin-

istration of the Act but it is also a question on which there is a clear split between the holdings of Courts of Appeals. In *Brouk* v. *Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), *cert. granted*, 366 U.S. 958, *judgment vacated as moot*, 369 U.S. 424 it was held that no private right of action, such as the one Respondent seeks to assert in this case, arises under the Act. Directly contrary to that case is *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961).

Assuming arguendo that a shareholder of a registered investment company can assert a private cause of action under the Act on behalf of his company, there still remains the very substantial question whether Section 37 of the Act 15 U.S.C. § 80a-36, proscribes, as criminal larceny, embezzlement or willful conversion, the open payment or receipt of compensation pursuant to a contract authorized by the Act and adopted and approved by stockholders in the manner called for by the Act. Respondent's claim that Petitioners have violated Section 37 of the Act rests entirely upon his assertion that the advisory fees are "excessive" and his other assertions which can best be described as "boiler plate" allegations usually found in stockholder derivative suits claiming mismanagement and waste of corporate assets. Nowhere in the Act is there any attempt by Congress to regulate or limit the size of investment advisory fees, and it is a wholly unwarranted extension of the Act to construe Section 37, dealing as it does with criminal larceny, embezzlement and willful conversion, as blanket authority for the federal courts to substitute their judgment for that of the shareholders and directors concerning the compensation to be paid the investment adviser.

Finally, it is a matter of great importance not only to the Petitioners in this action but to the investment company industry generally that the primary jurisdiction of the Securities and Exchange Commission be recognized with respect to any claim that a natural person is controlled by another within the meaning of the Act. Section 2(a)(9) of

the Act, 15 U.S.C. § 80a-2(a)(9), expressly provides that a natural person shall be presumed not to be a controlled person and that such presumption "shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person."

Many relationships and actions of investment companies are permitted by the Act subject to restrictions or prohibitions which depend upon non-existence of "control" or affiliation through such control. The conduct of an investment company's affairs would be difficult—even almost impossible—if its officers and directors could not rely upon the presumption of lack of control.[1] Congress accordingly vested in the Commission primary jurisdiction to determine when, if at all, this statutory presumption should be overturned in cases such as the present.

The Commission, despite the plain statutory language, has stated that, when the same issue is pending before a court, primary jurisdiction to determine questions of control under Section 2(a)(9) does not rest with the Commission. *In the Matters of Fundamental Investors, Inc.; Investors Mutual, Inc.; Television-Electronics Fund, Inc.*, Investment Co. Act Release No. 3596 (December 27, 1962), —S.E.C.—, Fed. Sec. L. Rep. ¶ 76,887. However, this *dictum* by the Commission indicated that it did not recognize the principles upon which the doctrine of primary jurisdiction rests. The Commission failed to recognize that the real issue presented to a court in an action such as the present is whether the court should proceed without the benefit of action by the agency entrusted with regulating

[1] Not presented by either the appeal below or this petition is the question whether there can ever be any retroactive civil liability for transactions occurring prior to a proper determination that such control does exist. The only question now presented is whether the Commission has primary jurisdiction to make a determination as to the existence of control.

the industry or whether the court should proceed only after it can take into account the administrative position on the particular problem.

Should not the agency charged with the regulation of the investment company industry and fully acquainted with the intricate facts and relationships which might bear on the issue of control be the one initially to grapple with the difficult problems which affect the particular parties and the industry as a whole? Initial consideration of these problems by the Commission is particularly important since the fashioning of a rule as to what should constitute "control" necessarily involves substantial policy considerations with regard to the application and enforcement of the Act.

Furthermore, the Congress has expressly empowered the Commission to exempt conditionally or unconditionally any person or transaction from any provision of the Act when necessary or appropriate in the public interest and consistent with the protection of investors and the purposes and policies of the Act, Section 6(a), 15 U.S.C. § 80a-6(c). Thus, even though the Commission might find control of individuals in a particular situation involving directors of an investment company, the Commission might nevertheless exercise its exemptive power so as to give the finding prospective effect only, or so as to limit its application to less than all the transactions or relationships which various sections of the Act might otherwise condemn.

A finding of control by a court in connection with an implied cause of action under the Act, cannot be tempered in the same manner. Congress has not authorized courts to grant exemptions from provisions of the Act. This discretionary power was given only to the Commission, as was the power to overturn the statutory presumption against control. Plainly, the Commission should be given at least the initial opportunity to act on these matters specifically committed to it by Congress.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

CIVIL ACTION
No. 63-689

S. HAROLD LEVITT, EXECUTOR
PLAINTIFF

v.

EDWARD C. JOHNSON 2D, ET AL.
DEFENDANT

Opinion of the District Court

Benedict Wolf, New York City, argued the motion, and *S. Roy Remar*, Boston, Mass., of counsel, for plaintiff.

Edward B. Hanify, Boston, Mass., argued the motion, and *Ropes & Gray, Joseph P. Rooney* and *Gaston, Snow, Motley & Holt*, Boston, Mass., for corporate defendants (other than Fidelity Capital Fund) and defendant Johnson.

James D. St. Clair and *Hale & Dorr*, Boston, Mass., for individual defendants other than defendant Johnson.

Sumner H. Babcock and *Bingham, Dana & Gould*, Boston, Mass., for defendant Fidelity Capital Fund.

OPINION

October 21, 1963

WYZANSKI, District Judge.

This is a stockholder's derivative action seeking to prosecute on behalf of a Massachusetts corporation, Fidelity

Capital Fund, Inc. (hereinafter called "Fund") a claim that its directors and others injured the corporation by violations of the federal Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, (hereinafter called the Act), and by waste of corporate assets in violation of the law of the Commonwealth of Massachusetts. Most of the claimed violations and waste are related to the allegedly excessive advisory fees which Fund paid to Fidelity Management & Research Company (hereinafter called FMR), pursuant to an Advisory and Service Contract made on January 28, 1958, amended March 12, 1958, and, admittedly, "approved by the stockholders on March 15, 1961." [Complaint, par. 10].

Plaintiff's capacity to bring this action is alleged in the complaint as follows:

> "2. Plaintiff is the Executor of the Estate of Martin M. Levitt, Letters Testamentary having been issued to him by the Probate Court of Cook County, Illinois, on July 11, 1962. Martin Levitt, the decedent, owned stock in the Fund continuously from April 15, 1959, to the date of his death on June 26, 1962, and said stock has remained in his estate continuously from that date to the present time. Plaintiff was appointed Ancillary Administrator by Decree, Suffolk Probate Court, Docket number 424569."

Defendants include Fund, its directors, FMR, and three other corporations.

The wrongs claimed to have been committed by defendants are extensively set forth in the 20 page complaint. For present purposes, the following three paragraphs illustrate, without comprehensively summarizing, the kind of wrongs alleged:

1. The contracts set terms grossly unfair to Fund, and constituted embezzlement in violation of § 37 of the Act, in-

asmuch as (a) fees were based on a fixed percentage of Fund's net assets, and hence increased in direct proportion to the increase in such assets, (b) fees were at rates higher than those charged by FMR and by others for similar services, and (c) the rates fail to reflect the fact that FMR primarily advises other investment trusts which get much of the benefit of what FMR does for Fund.

2. The contracts were not the result of arm's length bargaining but were adopted as a result of gross negligence of, and disregard of duty by, the directors of Fund. The directors made and renewed these contracts without pressing for a reduction of the rates as assets increased, without adequately considering possible advisers other than FMR, and without seeking a proper allocation among FMR's different clients of the service charges.

3. A majority of Fund's directors have been persons affiliated, within the meaning of § 2(a) (3) of the Act, with FMR and therefore the contracts were in violation of §§ 10(a) and 10(b) of the Act and were null and void under § 47 of the Act.

Most of the wrongs are alleged to have continued until the complaint was filed.

The complaint recites that it would have been futile for plaintiff to make demand upon Fund's Board of Directors because they are among the alleged wrongdoers. Then with respect to a demand upon stockholders, the complaint recites:

> "44. Demand upon the stockholders of the Fund to bring this action is unnecessary and would be futile because:
>
> "(a) The transactions complained of were in violation of the law and constituted a waste of corporate assets

and are therefore incapable of ratification by less than the unanimous vote of all of the stockholders.

"(b) Under the charter and by-laws of the Fund, the management of its affairs, including the bringing of suits, is entrusted to the Board of Directors, and not to the stockholders. The stockholders cannot, by resolution or otherwise, require the Fund or its Board of Directors to bring an action.

"(c) A stockholder resolution demanding the bringing of a suit would be futile since control of the action would be in the hands of the very persons who are alleged to be the wrongdoers and cannot be properly prosecuted by them.

"(d) The Fund has more than 48,000 stockholders scattered all over the United States whose identity is subject to frequent changes. A demand upon the stockholders to take action would cast an unconscionable financial burden on the plaintiff in that the plaintiff would have to solicit proxies from all of the stockholders residing in every State of the Union and foreign countries. It would involve the conduct of a proxy fight, a proxy fight which would entail prohibitive expenses and would cause undue loss of time with the danger that the claims alleged might be barred by the Statute of Limitations."

In conclusion, plaintiff prays that the contracts between Fund and FMR be declared void, that defendants repay to Fund all investment advisory fees received by them since April 1959, and that defendants account to Fund for their profits resulting from the matters alleged.

Defendants have moved to dismiss the complaint on the grounds that this Court lacks jurisdiction of the subject matter, that the complaint does not comply with the requirements of Fed.Civ.Proc. Rule 23(b), and that the complaint fails to state a claim upon which relief can be granted. Supporting affidavits were served by defendants

by mail on October 4, 1963. Cf. Rule 5(b). By their brief, filed October 11, defendants request that their "motions should be treated as ones for summary judgment", as permitted by the last sentence of Rule 12(b).

Supplementing their written motions, defendants have suggested that the Court should dismiss this action because, as defendants' affidavit shows, the Massachusetts Probate Court, contrary to the recital in the complaint, had not in fact appointed S. Harold Levitt as ancillary administrator.

I.

This Court has jurisdiction over the subject matter of the complaint. 15 U.S.C. § 80a-43; *Brown* v. *Bullock,* 2nd Cir., 294 F.2d 415.

II.

Plaintiff has capacity to bring this action. According to the complaint, the Illinois probate court issued to plaintiff as executor letters testamentary on July 11, 1962; from then until August 15, 1963, when this complaint was filed, he held the legal title to shares in Fund; and part of the wrongs are alleged to have been caused during that period. In other words, plaintiff sues as a trustee holding the legal title of Fund shares as part of an Illinois estate not only as the representative of a decedent. Plaintiff is entitled to complain in the United States District Court for the District of Massachusetts of an injury to the corporation caused during the time he was the legal owner, even if the ownership was for the benefit of others. Cf. Restatement, Conflict of Laws § 508; *Talmage Adm.* v. *Chapel,* 15 Tyng 71, 73; *Cannon* v. *Cannon,* 228 N.C. 211, 45 S.E. 2d 34; Goodrich, Conflict of Laws, § 189 (3rd ed. 1949); Ehrenzweig, Conflict of Laws, p. 48. The situation is unlike that where

the cause of action is based exclusively on transactions occurring during the life of the decedent. Those would fall within the oft-criticized rule (see Ehrenzweig, Conflict of Laws, p. 45, note 3) that federal and state courts in one state will not take jurisdiction of suits by executors and administrators appointed in another State where the cause of action was one which belonged to the decedent. *Dixon's Executors* v. *Ramsay's Executors,* 3 Cranch 319, 323, 2 L.Ed. 453; *Kerr* v. *Moon's Devisees,* 9 Wheat. 565, 571, 6 L.Ed. 161; *Vaughan* v. *Northrup,* 15 Pet. 1, 5, 10 L.Ed. 639. See *Moore* v. *Mitchell,* 281 U.S. 18, 24, 50 S.Ct. 175, 74 L.Ed. 673, Restatement, Conflict of Laws § 507; Atkinson, The Uniform Ancillary Administration and Probate Acts, 67 Harv.L.Rev. 619, 621, note 9. Thus, even if it be true that at the time this action began the Massachusetts probate court had not appointed plaintiff as ancillary administrator, the complaint should not be dismissed for want of plaintiff's capacity to sue.

III.

The complaint complies with Fed. Civ. Proc. Rule 23(b). It meets the procedural obligation to set forth with particularity the reasons for plaintiff not making an effort to obtain action from the shareholders.

IV.

The problem is whether plaintiff, in addition to fulfilling the procedural requirements of the aforesaid Rule 23(b), has also fulfilled, in the terminology of *Hausman* v. *Buckley,* 2nd Cir., 299 F.2d 696, 701, the "substantive" conditions precedent with respect to the obligations, if any, of a shareholder, in a derivative action, to make demand upon his fellow shareholders.

A.

The initial inquiry must be what law governs those substantive conditions. The conventional rule is that the local law of the state of incorporation determines the right of a shareholder to participate in the administration of the corporation and to act as its representative in pursuing a claim. See Restatement of the Law Second, Conflict of Laws, Tentative Draft No. 7 (April 16, 1962) § 183, pp. 104-106; Restatement, Conflict of Laws [First] § 183, especially comment (b). Consistently with that principle, the local law of the state of incorporation, in this case Massachusetts law, determines whether before initiating a stockholder's purely derivative action a stockholder must first make application to the stockholders. *Hausman* v. *Buckley,* 2nd Cir., 299 F.2d 696, 702, 706; *Steinberg* v. *Hardy,* D.Conn., 90 F.Supp. 167, 169; *Newman* v. *Baldwin,* 13 Misc.2d 897, 179 N.Y.S.2d 1[illegible]; Restatement of the Law Second, Conflict of Laws § 183, Reporter's note, p. 105; Ehrenzweig, Conflict of Laws, p. 38.

Reference to the law of the state of incorporation to determine whether a stockholder has the substantive right to bring a derivative action for his corporation remains appropriate even if the claim which the corporation has against the alleged wrongdoer is based on a federal statute. It is that principle which explains the opinion of Justice Brandeis in *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 264, 37 S.Ct. 509, 510-511, 61 L.Ed. 1119 that "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation." That principle also explains Justice Douglas's opinion in *Price* v. *Gurney,* 324 U.S. 100, 107, 65 S.Ct. 513, 516-517, 89 L.Ed. 776 that

"nowhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition in behalf of the corporation." *Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Corp.*, 326 Mass. 99, 105, 93 N.E.2d 241, 244 is in accord, for there, Massachusetts law governed the right of a stockholder to present a derivative claim of his corporation that it had been injured by contracts which "violated the Federal anti-trust laws." In the light of those authorities this Court declines to follow the contrary doctrine enunciated in *Rogers* v. *American Can Co.*, 3rd Cir., 305 F.2d 297, 304 col. 2, last paragraph, 317 col. 2, holding that the derivative right of a stockholder to present his corporation's claim of damage for injuries caused by violation of the federal antitrust laws is a right determined by federal law, and cannot be cut off by an honest vote of a majority of the stockholders.

No doubt, in enacting a regulatory statute designed for the benefit of shareholders, such as the Investment Trust Act of 1940, Congress might provide that a stockholder, in addition to his derivative right to assert his corporation's claim, shall have a direct right against a person whose violation of the law causes damage to a corporation and that the direct right of a shareholder to bring such suit shall not be subject to curtailment by the corporation, by the majority of its shareholders, by local law of the state of incorporation, or by anyone else. But in the present Act there is no express provision to this end. To imply such a direct right, supplementing the derivative right, on the theory there should be a national, not a purely state, rule governing the right of a shareholder to sue on account of a viola-

tion of a national statute, or on the theory that it would be an effective way of enforcing a national regulatory statute, of deterring and punishing wrongdoers, and of assuring shareholders that they would not be mulcted of their assets, is not within the proper exercise of judicial power. But see to the contrary *Rogers* v. *American Can Co., supra,* particularly at p. 317 of 305 F.2d. Such an implication, unsupported by statutory text, legislative history, or case law with respect to similar statutes, seems to be impermissible judicial legislation defying principles almost universally accepted, as shown by the Restatements and by the opinions of Justices Brandeis and Douglas for a unanimous Supreme Court.

In short, Massachusetts law governs the substantive right of plaintiff to present derivatively his corporation's claim, and determines whether as a condition precedent, plaintiff must make demand upon his fellow shareholders.

B

Massachusetts law with respect to the requirement of demand upon fellow stockholders, depends upon the Massachusetts view of the power possessed by a disinterested majority of stockholders acting in good faith. The latest authoritative pronouncement of the Massachusetts view is *Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E.2d 241 in which Wilkins, J., now Chief Justice, wrote the opinion.

The Court in Solomont stated 326 Mass. at p. 100, 93 N.E.2d 241:

> "The principal question, presented by the sustaining of pleas to the bill of complaint, is whether an independent, disinterested majority of the stockholders, acting reasonably and in good faith, can effectively vote that in

their judgment it is not in the best interest of a corporation to assert on its behalf certain claims against its principal executives and others."

According to plaintiff Solomont's complaint, officers and directors of the corporation in which Solomont held shares had caused the corporation to enter into contracts under which those officers and directors received excessive payments, and "the contracts are also alleged to have violated the Federal anti-trust laws." (326 Mass. p. 105, 93 N.E.2d p. 244). Shortly before plaintiff sued, "at a meeting of the stockholders * * * a majority, acting reasonably, in good faith, and according to their own judgment as to what was in the best interest of the corporation, had voted not to assert the causes of action upon which the suit is grounded, and in all but one instance had ratified and approved them." (326 Mass. p. 105, 93 N.E.2d p. 244).

The Court noted (326 Mass. p. 111, 93 N.E.2d p. 247):

"Much of the plaintiffs' argument is devoted to limitations upon the power of the stockholders to ratify wrongs to a corporation. Dana v. Morgan, 219 F. 313, 315 (D.C. S.D.N.Y.), affirmed 232 F. 85 (C.C.A. 2). Hodgman v. Atlantic Refining Co., 300 F. 590, 599 (D.C. Del.), certiorari denied 273 U.S. 731 [47 S.Ct. 240, 71 L.Ed. 863] Continental Securities Co. v. Belmont, 206 N.Y. 7, 16-18 [99 N.E. 138, 51 L.R.A.,N.S., 112]. Pollitz v. Wabash Railroad, 207 N.Y 113, 127 [100 NE. 721]; United States Steel Corp. v. Hodge, 19 Dick. (N.J.) 807, 814, 817-818 [64 N.J.Eq. 807, 54a-1, 60 L.R.A. 742]. Cook, Corporations (8th ed.) § 730, Fletcher, Cyc. Corporations, § 5795. We shall not rest our decision upon any power to ratify. The question whether it is good judgment to sue is quite apart from the question of ratification. This is a distinction of substance and not of form."

The Supreme Judicial Court held that if, as a matter of honest business judgment, the majority of stockholders

voted that there should not be presented corporate claims based on waste of corporate assets, gross breach of fiduciary duty, violation of federal law, and other misconduct which the stockholders lacked power to ratify, a minority stockholder could not thereafter prosecute the corporate claims.

The quotations already given from the Solomont case, the citations in those quotations of leading cases from other jurisdictions which recognize the contrary doctrine that a minority stockholder can bring a suit based on a corporate claim of waste or violation of law, and the thoroughness with which distinguished counsel and the Court examined the questions presented, are persuasive indications that Massachusetts would adhere today to the rule that a minority shareholder cannot bring a derivative suit to enforce a claim that a majority of his fellows in good faith have determined not to present. [Note The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review 63 Columbia L.Rev. 1086, 1096-1097.]

There is no reason to suppose that the Massachusetts state court would alter its rule in the light of *Gottesman* v. *General Motors Corp.*, 2nd Cir., 268 F.2d 194, 197 and *Rogers* v. *American Can Co.*, 3rd Cir., 305 F.2d 297, 311, 315. Both those cases are bottomed on *Continental Securities Co.* v. *Belmont* and *Pollitz* v. *Wabash Railroad*, which Wilkins, J. cited and refused to follow. Moreover, in the Rogers case, Forman, J.'s opinion acknowledges that he is rejecting the Massachusetts rule. See 305 F.2d at pp. 310-311.

Nor is there any reason to suppose that the Massachusetts Supreme Judicial Court would accept the following

criticism in Note, Demand in Derivative Suits, 73 Harv.L. Rev. 746 (1960) at p. 762:

> "With due regard to courts and commentators who have concluded that a refusal to sue may be proper though a ratification is not possible, it seems clear that a state's statutory or decisional law which holds certain wrongs nonratifiable evinces a policy which means to give the minority shareholder the power to redress these wrongs after directors and majority shareholders have declined to do so."

Despite what is said in the foregoing note and in some passages in the Gottesman and Rogers cases, Judge Wilkins is surely right, in the above quotation from page 111 of the Solomont case [at page 111 of 326 Mass., at page 247 of 93 N.E.2d], that there are differences of substance and policy between the capacity of a corporation to ratify a violation of law and the capacity of a corporation's shareholders to preclude a corporate claim from being civilly pursued. The capacity not to permit a civil suit is closely akin to the capacity to approve a binding settlement at less than 100% of the claim. Where the majority decide that a corporate claim should not be carried further either by them or by any dissenting stockholder, they are not affecting the criminal liability of the wrongdoer, they are not interfering with a presentation of a stranger's claim, they are not guilty of condonation.

The Massachusetts doctrine treats a good-faith majority of shareholders as having the quasi-legislative power to exercise an honest business judgment that it is in the interest of the corporation and its shareholders as a group that a particular corporate claim should not be pressed at all, or not pressed beyond a particular settlement point. No one, presumably, doubts that under some circumstances it may be good business judgment not to press to its pos-

sible legal limits a corporate claim against a wrongdoer. Without exhaustive illustration, it is enough to mention the time and effort required of corporate officers to testify in a court proceeding even if a minority stockholder is the active plaintiff; or the effect upon the corporation's public relations of some suits; or the justified reluctance, particularly after a wrongdoer has been removed from responsibility, to exact the last pound of flesh. To be sure, exacting anything less than the last pound may imply that each shareholder's indirect interest in the assets of the corporation may be somewhat less valuable than was theoretically possible. But under the Massachusetts rule each person when he becomes a shareholder accepts a system in which to determine whether a corporate claim shall be pursued, settled, or precluded from any further civil litigation, the authorized tribunal is the majority of the shareholders acting in good faith. Such a system is inherently fair. There are risks in this system,—though the risks may be minimized if it is recognized that a majority of the shareholders can hardly be said to have acted in good faith in cutting off the right of one of their number to present at his own expense a corporate claim unless the majority have given him a fair hearing. [Cf. Note The Nonratification Rule and The Demand Requirement: The Case For Limited Judicial Review. 63 Col.L.Rev. 1086, 1103-1104.]

Moreover, not to adopt the Massachusetts rule also has its risks. To permit dissenters to override the honest majority's determination that a corporate claim should not be pursued, or not pursued to its legal limit, carries the possibility that no corporate claim can be finally disposed of without judicial approval. It carries the possibility of a dissenter pursuing a claim which though it may prevail will never yield any net amount to the corporate treasury, after the payment of counsel fees and after a fair allowance for

the time of the corporate employees in preparing and offering testimony. Reasonable minds may differ as to whether those potential disadvantages are overbalanced by the desirability of supplementing the prosecuting and visitatorial functions of the attorney general, district attorneys, and administrative agencies, by allowing a dissenting stockholder, without specific statutory authority conferred upon him, and against the expressed views of a majority of his fellows, to bring a civil action to vindicate the public interest in deterring malefactors. Minority stockholder suits are unquestionably effective deterrents; yet, like *qui tam* suits, they have mixed consequences in the larger effort to establish the good society.

Massachusetts having resolved the competing considerations by adopting a rule that a majority of shareholders acting in good faith may preclude a minority from prosecuting a corporate claim, that rule governs a federal court in any case (not only a diversity jurisdiction case) involving a shareholder of a Massachusetts corporation seeking to press derivatively that corporation's claim. The situation is different from a case where a stockholder's claim arises under a national or local law which gives, expressly or impliedly, each stockholder a direct right against a wrongdoer as well as a derivative interest in his corporation's chose-in-action.

C.

It is partly because under the Solomont rule in Massachusetts a majority of stockholders acting in good faith have the right to thwart any derivative suit by one of their fellows that a shareholder in a Massachusetts corporation, before he brings a derivative suit, must make demand upon

the other stockholders. As Judge Aldrich said in *Halprin* v. *Babbitt* (1st Cir., 1963), 303 F.2d 138, 141:

> "The nature and function of this demand admit of some divergence of views. See Note, Demand in Derivative Suits, 73 Harv.L.Rev. 746 (1960). We believe that the form should be a demand that the majority cause proceedings to be instituted, and that the purposes are two. The first is to permit the majority to take some sort of affirmative action itself. The second is to permit the majority to decide, as in Solomont, that no action be taken by anybody."

It is only when the complaint alleges that the majority are corrupt or are otherwise incapable of acting in good faith that the demand upon the body of stockholders may be excused. *Bartlett* v. *N. Y., N. H. & H. R. Co.*, 221 Mass. 530, 109 N.E. 452; *Pomerantz* v. *Clark*, D. Mass., 101 F.Supp. 341; *Carroll* v. *New York, N. H. & H. R. R.*, D.Mass., 141 F.Supp. 456

Plaintiff's excuses set forth in the already quoted paragraph 44 of the complaint do not satisfy the Massachusetts rule. Because of the Solomont rule, with respect to Massachusetts corporations, (regardless of the situation with respect to corporations organized under the law of other states, see Note, Demand in Derivative Suits, 73 Harv.L. Rev. 746, 755-758) it does not matter whether, as paragraph 44 alleges, (a) the transactions complained of were incapable of ratification, or (b) the stockholders cannot require the directors to sue, or (c) any suit at the request of the stockholders would be in the hands of the alleged wrongdoers, or (d) demand would be expensive and otherwise burdensome.

Because of the failure to plead that plaintiff complied with the strict Massachusetts rule as to prior demand upon his fellow shareholders in Fund, the complaint fails to state a cause of action.

Complaint dismissed.

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 6249.

S. HAROLD LEVITT, EXECUTOR,

PLAINTIFF, APPELLANT,

v.

EDWARD C. JOHNSON 2d, ET AL.,

DEFENDANTS, APPELLEES.

APPEAL FROM THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF MASSACHUSETTS

Before WOODBURY, *Chief Judge,* and HARTIGAN and ALDRICH, *Circuit Judges.*

Paul L. Ross, with whom *S. Roy Remar, Benedict Wolf,* and *Wolf Popper Ross Wolf & Jones* were on brief, for appellant.

Edward B. Hanify, with whom *Truman S. Casner, Joseph P. Rooney, Ansel B. Chaplin, Sumner H. Babcock, James D. St. Clair, Ropes & Gray, Gaston, Snow, Motley & Holt, Bingham, Dana & Gould,* and *Hale & Dorr* were on brief, for appellees.

Philip A. Loomis, Jr., General Counsel, *Walter P. North,* Associate General Counsel, *George P. Michaely, Jr.,* Special Counsel, and *Paul J. Kemp,* Attorney, on brief for Securities and Exchange Commission, Amicus Curiae.

OPINION OF THE COURT.

July 8, 1964.

ALDRICH, *Circuit Judge.* This is a suit by a minority stockholder of Fidelity Capital Fund, Inc., a Massachusetts corporation, on behalf of himself and other interested stockholders for the benefit of the corporation. The defendants, in addition to the corporation, are individuals, now or formerly directors, and several corporations sought to be charged with conduct in violation of the Investment Company Act of 1940, 15 U.S.C. §§80a-1 *et seq.*, hereinafter the act.[1] The conduct said to be in violation of the act is described in the opinion of the district court, 222 F. Supp. 805, and may be summarized for present purposes as the charging of improper and excessive fees. The district court dismissed the action solely because of plaintiff's failure to allege a prior demand upon the other stockholders, and did not reach the questions defendants attempted to raise on the merits by a motion for summary judgment. Defendants draw our attention to this motion as an alternative basis for sustaining the dismissal, but we are disinclined to pass upon such a motion not considered below, absent a clear showing of its inescapable correctness. This is a complicated action. The eventual record may well raise isssues in a somewhat different form, and we do not wish at this juncture to attempt comprehensive rulings. For now, we think it sufficient to say that at least some basis for recovery was well pleaded, and that with regard to defendants' claim of acquiescense or waiver there appears to be at least an issue of fact.

The district court correctly decided that the plaintiff had complied with the procedural requirements of F.R.

[1] The complaint also charged common law violations, but the dismissal of those causes is not complained of.

Civ. P. 23(b), by stating, *inter alia,* the reasons he made no prior demands upon the directors and upon the stockholders. As a matter of substance it is conceded that his reason as to the former, namely, that a majority of the directors were, allegedly, involved in the claimed malfeasance and misfeasance, is adequate. With respect to the stockholders, plaintiff asserts, *inter alia,*

> "Fund has more than 48,000 stockholders scattered all over the United States whose identity is subject to frequent changes. A demand upon the stockholders to take action would cast an unconscionable financial burden on the plaintiff in that plaintiff would have to solicit proxies from all of the stockholders residing in every State of the Union and foreign countries. It would involve the conduct of a proxy fight, a proxy fight which would entail prohibitive expenses and would cause undue loss of time with the danger that the claims alleged might be barred by the Statute of Limitations."

While defendants contend that this is an inadequate excuse for not making a demand upon the stockholders under what might be termed the federal rule if it, rather than some special rule of some particular state, obtains, we disagree. We disagree also with their contention that, if there is a difference, the state rule is the one to be applied.

The explanation of our disagreement requires an analysis of the reasons for requiring an a priori demand. In *Halprin* v. *Babbitt,* 1 Cir., 1962, 303 F.2d 138, at 141, in discussing these reasons, we said there were two. "The first is to permit the majority to take some sort of affirmative action itself. The second is to permit the majority to decide, as in *Solomont,* [*infra*] that no action be taken by anybody." This, however, is not an answer to the present question. In *Halprin* v. *Babbitt, supra,* 92% of the company's stock was held by one stockholder. We were not, in other words, speaking in the context of 48,000 stock-

holders, or as to when such a circumstance might constitute an excuse. Nor does *Halprin*, which was a diversity case, answer the question of what law presently governs.

The district court stated that the law of the state of incorporation normally determines a stockholder's rights, and that this is so with respect to any derivative action "even if the claim which the corporation has against the alleged wrongdoer is based on a federal statute." For this it cited *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 1917, 244 U.S. 261 and *Price* v. *Gurney*, 1945, 324 U.S. 100. It then stated that it found nothing in the act to suggest that Congress intended to give shareholders "a direct right, supplementing the derivative right." From this it concluded that Massachusetts law must control, and that in view of *S. Solomont & Sons Trust, Inc.* v. *New England Theatres Operating Corp.*, 1950, 326 Mass. 99, the plaintiff was not excused from making the demand. It accordingly dismissed the complaint.

Solomont did not involve the present question, but decided solely that a majority of disinterested stockholders could vote that an action against the directors, even though valid, should not be pursued. The district court concluded that this meant that Massachusetts would not excuse a demand on the majority stockholders, unless, following the directors analogy, they were not disinterested. We do not believe this follows. The fact that a majority of informed disinterested stockholders might decide, for reasons discussed in *Solomont*, that a suit should not be prosecuted, does not mean that they must be fully instructed in every instance before the suit is instituted. As we pointed out in *Halprin* v. *Babbitt, supra*, the minority does not have to obtain the express authorization of the majority before s .t is commenced. The demand upon the majority, in other words, does not have this broad purpose. Neither of the

more limited purposes we outlined in *Halprin* could be accomplished in any real sense unless the demand evoked a full and fair consideration of the issues, in depth, by the other stockholders.[2] If their number is small, as in *Halprin*, and the minority could reasonably be expected to put its case before them, it should be obliged to do so. However, on the allegations of the present complaint not only would such a burden be enormous, but no disclosure that plaintiff could be expected to make would be likely to persuade a majority to take over the action, or, conversely, permit an informed decision by the majority that the action be not instituted.[3]

As a pointless or, alternatively, impossibly burdensome act it should be excused. *Gottesman* v. *General Motors*

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[2] For present purposes we are assuming, but not deciding, that under both state and federal law a fully informed majority, unbiased and unled in any way by the directors, might decide over the wishes of the minority that a claim involving a violation of the act should not be pursued. *But cf. Rogers* v. *American Can Co.*, 3 Cir., 1962, 305 F.2d 297.

[3] Nowhere has this been better stated than in the opinion of the district court in *Pomerantz* v. *Clark*, D.Mass., 1951, 101 F.Supp. 341, where it was said at 346, "To prevent these minority members from suing until they have acquired the support of a majority of their fellows is in most cases to throttle them. They must move against inevitable inertia which always favors the *status quo*, the respectable and the powerful, particularly if, regardless of wrongdoing, a particular company has prospered. They rarely have large funds at their command to circularize and arouse their fellows. And, above all, they are not in a position to state the details of wrongdoing which would persuade unprejudiced men until after they have brought suit and had the advantage of testimonial compulsion." See, also, Baker & Cary, Cases on Corporations (3d ed. 1959), p. 233: "Statistics demonstrate that in most instances stockholder proposals receive a minimal percent of the total votes cast." Newcomer, The Big Business Executive, (1955), p. 9: "In a corporation whose stock is widely distributed the possibility of dissatisfied stockholders mustering the necessary votes to force a change is very slim. It is easier to sell the stock. The cost alone is

Corp., 1959, 2 Cir., 268 F.2d 194, 197; *Citrin* v. *Greater New York Industries*, S.D.N.Y., 1948, 79 F. Supp. 692, 697; *Berg* v. *Cincinnati, N. & Co. Ry.*, ED. Ky., 1944, 56 F. Supp. 842, 845; *Pergament* v. *Frazer*, E.D. Mich., 1949, 93 F. Supp. 9, 13. But see *Haffer* v. *Voit*, 6 Cir., 1955, 219 F.2d 704, *cert. den.* 350 U.S. 832; *Bruce & Co.* v. *Bothwell*, S.D.N.Y, 1948, 8 F.R.D. 45, 47; *Varanelli* v. *Wood*, S.D.N.Y., 1949, 9 F.R.D. 61; *Levitan* v. *Stout*, W.D. Ky., 1951, 97 F. Supp. 105, 114.

We need not pursue the inquiry of whether the Massachusetts law is otherwise because if it is, it should not, in our opinion, be applied. In this suit based upon the Investment Company Act the question is not what state law normally determines a shareholder's rights, nor is it whether the act impliedly granted a shareholder a direct personal action, (*but cf. Borak* v. *J. I. Case Co.*, 7 Cir., 1963, 317 F.2d 838, *aff'd* U.S. 6/8/64), since this does not purport to be one. Rather, the question is whether the act contemplated or impliedly forbade the application to the assertion of derivative rights of what the court concluded to be a "strict Massachusetts rule." In this connection we note in section 1(b) a clear declaration of policy. The act is directed to "the national public interest and the interest of investors . . . adversely affected," and its "purposes . . . with which [its] provisions . . . shall be interpreted, are to mitigate and, *so far as is feasible, to eliminate* the conditions enumerated." (ital. suppl.) We do not see how it can be gainsaid that any substantial stiffening of the conditions precedent to the bringing of stockholders' suits above normal requirements would conflict with this broad

---

prohibitive, as was made abundantly clear in the recent New York Central upset. The cost of this proxy battle was estimated to be more than 1 million dollars. [Citing Fortune] Only when the dissatisfied minority has really important holdings, as in the case of the New York Central, is the chance of getting a new deal a real one."

declaration.[4] The district court's reasoning that since the stockholder's right is a derivative one his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation. See Note, 50 Va. L. Rev. 365 (1964).

Our views find support in the Supreme Court's recent opinion in *J. I. Case Co.* v. *Borak,* U.S. 6/8/64. In that case, involving the Securities Exchange Act of 1934, a stockholder sued to void the merger of his company with another corporation on the ground that the vote to accomplish the merger had been obtained by misrepresentations accompanying the proxy solicitation in violation of section 14(a) of that act. In upholding federal jurisdiction to redress the alleged violations the Court not only stated that the courts have power to implement the statute by devising appropriate forms of action to effectuate its purposes where Congress had not specifically done so, but rejected the contention that so doing would be an unwarranted

[4] Our attention has not been called to Rule 20(a) which the SEC has propounded requiring the company, when circulating proxies, to include stockholder statements not exceeding one hundred words, and consequently no argument has been based upon it. We do not think that any valid argument could be. Assuming that plaintiff were to phrase his demand in the form of a vote to bring suit which had to be put to the stockholders so as to receive the benefit of this rule, any contention that plaintiff could make full disclosure in a 100 word statement (the substantive portion of the present complaint, which is not unduly prolix, fills 13 pages) and receive thoughtful and adequate consideration, would be unrealistic. For discussion of the scope of this rule see Loss, Securities Regulation (2d ed. 1961) 1025, 900. That type of demand in our opinion would be meaningless. For a demand of sufficient proportions, assuming that plaintiff were required to make such, he would be on his own.

interference with domestic regulation at the state level. Particularly pertinent is the following language.

> "[W]e believe that the overriding federal law applicable here would where the facts required, control the appropriateness of redress despite the provisions of state corporation law, . . . [I]f the law of the State happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated. Furthermore, the hurdles that the victim might face (such as separate suits, . . . bringing in all parties necessary for complete relief, etc.) might well prove insuperable to effective relief."

We believe a rule under which a demand upon the majority stockholders is a condition that cannot be excused in a case such as this is the type of hurdle that the Investment Company Act, also, forbids.[5]

Judgment will be entered vacating the judgment of the District Court and remanding the action for further proceedings not inconsistent herewith.

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[5] We find nothing to the contrary in the cases cited by the court. *United Copper Securities* v. *Amalgamated Copper Co., supra,* held that the fact that the cause of action was based upon an alleged violation of the Sherman Act did not obviate, or reduce, the necessity of a demand by the minority stockholders. This is a quite different situation. As the SEC points out in its amicus brief filed herein in opposition to the "Massachusetts rule," there is a "great difference between the policy underlying the federal antitrust laws and that underlying the Investment Company Act. On the other hand, the policy of the antitrust laws is the preservation and protection of competition in our economy in its broadest scope. Those laws are thus geared to the protection of competing businesses, as businesses, whether in the corporate form or not. On the other hand, the policy of the Investment Company Act is to provide a comprehensive network of restrictions upon the organization, operation and management of investment companies to the end that individual investors might be protected." *Price* v. *Gurney, supra,* merely involved a question of the statutory jurisdiction of the bankruptcy court.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 6249.

S. HAROLD LEVITT, EXECUTOR,

PLAINTIFF, APPELLANT,

v.

EDWARD C. JOHNSON, 2ND, ET AL.,

DEFENDANTS, APPELLEES.

JUDGMENT

July 8, 1964.

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the District Court is vacated and the action is remanded for further proceedings not inconsistent with the opinion filed this day.

By the Court:

/s/ ROGER A. STINCHFIELD.
Clerk.

[cc.: Messrs. Ross, Hanify, St. Clair and Babcock.]

APPENDIX C

Pertinent Provisions of the Invesment Company Act of 1940

Section 2, 15 U.S.C. § 80a-2. *General Definitions.*

"(a) When used in this title, unless the context otherwise requires —

• • •

"(3) 'Affiliated person' of another person means . . . (C) any person directly or indirectly controlling, controlled by, or under common control with such other person; . . .

• • •

"(9) 'Control' means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

". . . A natural person shall be presumed not to be a controlled person within the meaning of this title. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person."

Section 10, 15 U.S.C. § 80a-10. *Affiliations of Directors.*

"(a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

"(b) After one year from the effective date of this title, no registered investment company shall —

• • •

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or affiliated persons of any of such principal underwriters; . . ."

Section 37, 15 U.S.C. § 80a-36. *Larceny and Embezzlement.*

"Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts."

Section 47, 15 U.S.C. § 80a-46. *Validity of Contracts.*

• • •

"(b) Every contract made in violation of any provision of this title or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation or order."

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IN THE

Supreme Court of the United States

October Term, 1964

No. 559

EDWARD C. JOHNSON 2D, et al.,
Petitioners,

v.

S. HAROLD LEVITT, Executor,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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IN THE

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v.

S. HAROLD LEVITT, Executor,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

Respondent opposes the Petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the First Circuit, entered in the above entitled case on July 8, 1964.

Jurisdiction

The Petitioners invoke the jurisdiction of this Court under 28 U. S. C. § 1254(1).

The judgment of the Court of Appeals entered in this case is not a final judgment. The judgment of the District Court dismissing the complaint was vacated and the action was remanded for further proceedings not inconsistent with the opinion of the Court (Pet. App. B, p. 40).

This Court has not entertained jurisdiction to review a non-final judgment, such as this one, remanding the case to the District Court for further proceedings, in the absence of some exceptional reason. *American Construction Co.* v. *Jacksonville, T. & K. W. Ry. Co.*, 148 U. S. 372, 384 (1893). In *United States* v. *General Motors Corp.*, 323 U. S. 373, 377 (1945), this Court agreed to review the decision because the correctness of the decision of the Court below depended upon the scope and meaning of a provision of the Federal Constitution. In *Land* v. *Dollar*, 330 U. S. 731, 734 (1947), and *Larson* v. *Domestic & Foreign Commerce Corporation*, 337 U. S. 682, 685 (1949), this Court entertained the petitions because the Courts below had ruled on the jurisdiction of the District Courts to entertain the actions.

No such compelling reason exists in this case.

Question Presented

Does Respondent's complaint in a derivative action on behalf of his Massachusetts corporation charging only violations of the Investment Company Act of 1940 (15 U. S. C. §§ 80a-1, *et seq.*), and pleading compliance with the procedural requirements of FRCP 23(b), state a claim upon which relief can be granted?

Statutes Involved

The pertinent provisions of Sections 1, 2, 10, 37, 44 and 47 of the Investment Company Act of 1940, 15 U. S. C. §§ 80a-1, 80a-2, 80a-10, 80a-36, 80a-43 and 80a-46 are set forth as Appendix "A" to this brief.

Statement

This is a stockholder's derivative action brought by Respondent, the executor of a deceased stockholder of Fidelity Capital Fund, Inc. (the "Fund"), a Massachusetts corporation, against individuals now or formerly directors of the Fund, the Fund's investment advisor and principal underwriter and another investment company. Respondent seeks an accounting and recovery of money damages for alleged violations of the Investment Company Act of 1940, 15 U. S. C. 80a-1 *et seq.*, hereinafter sometimes referred to as the Act. The Fund, in behalf of which the action was brought, was named a party defendant.

The Fund is registered under the Investment Company Act of 1940 as a diversified open-end management investment company. The shares of the Fund have been and are being offered for sale widely and are sold to the public on a continuous basis.

The individual Petitioners have been the directors of the Fund since its inception in 1959 and, except for Petitioners Brown and Wheeler, have functioned continuously as such directors. Petitioner Johnson is president of the Fund.

The wrongs claimed to have been committed by Petitioners are extensively set forth in the complaint (R., pp. 2-18). The following three paragraphs illustrate, without comprehensively summarizing, the kind of wrongs alleged:

1. The contracts set terms grossly unfair to Fund, and constituted embezzlement in violation of § 37 of the Act, inasmuch as (a) fees were based on a fixed percentage of Fund's net assets, and hence increased in direct proportion to the increase in such assets, (b) fees were at rates higher than those charged by Fidelity Management

& Research Company (hereinafter called FMR) and by others for similar services, and (c) the rates fail to reflect the fact that FMR primarily advises other investment trusts which get much of the benefit of what FMR does for Fund.

2. The contracts were not the result of arm's length bargaining but were adopted as a result of gross negligence of, and disregard of duty by, the directors of Fund. The directors made and renewed these contracts without pressing for a reduction of the rates as assets increased, without adequately considering possible advisors other than FMR, and without seeking a proper allocation among FMR's different clients of the service charges.

3. A majority of Fund's directors have been persons affiliated within the meaning of § 2(a)(3) of the Act, with FMR, and therefore the contracts were in violation of §§ 10(a) and 10(b) of the Act and were null and void under § 47 of the Act.

Most of the wrongs are alleged to have continued until the complaint was filed.

The complaint recites that it would have been futile for plaintiff to make demand upon the Fund's Board of Directors because they are among the alleged wrongdoers (R., p. 15, para. 43). Facts excusing demand upon the stockholders are alleged in paragraph 44 (R., p. 16).

Respondent prayed that the contracts between the Fund and the advisor be declared void; that Petitioners repay to the Fund all investment advisory fees received by them since April, 1959, and that Petitioners account to the Fund for their profits resulting from the matters alleged (R., p. 17).

The complaint also originally pleaded as a pendent claim that the conduct described constituted mismanagement and waste of corporate assets, in violation of Massachusetts law.

In his reply brief in the Court of Appeals (p. 6), the Respondent stated:

> "The plaintiff has, after careful consideration, decided to rest on his basic complaint which asserts a federal claim flowing from violations by the appellees of the Investment Company Act of 1940.
>
> "Therefore, we ask leave to withdraw the pendent claim (complaint, para. 1, A-2) and consent that there be stricken from the complaint (Para. '42', A-15) the following words:
>
> 'and the laws of the state of Massachusetts'
>
> "Thus, there remains for determination only the validity of the federal claim based upon violations of the federal statute."

In connection with this common law cause of action, the Court of Appeals noted in footnote 1 to its Opinion (Pet., App. B, p. 33) the following:

> "The complaint also charged common law violations, but the dismissal of those causes is not complained of."

Proceedings Below

The Petitioner moved in the District Court to dismiss the complaint on the following grounds:

> (I) That the district Court lacks jurisdiction of the subject matter;
>
> (II) That Respondent lacked capacity to bring this action;
>
> (III) That the complaint does not comply with the requirements of FRCP Rule 23(b);
>
> (IV) That the complaint fails to state a claim upon which relief can be granted.

The District Judge overruled the motions addressed to objections numbered I, II and III. He sustained the objection numbered IV and dismissed the complaint.

The District Judge found that the complaint complies with Federal Civil Procedure Rule 23(b) but held that Massachusetts law governs the substantive right of Respondent to present derivatively his corporation's claim. He held that Massachusetts law requires demand upon his fellow stockholders. Absent allegation of such demand, the complaint was insufficient.

The Respondent appealed to the Court of Appeals for the First Circuit. No cross-appeal was filed by Petitioners. The Court of Appeals entered judgment vacating the judgment of the District Court dismissing the complaint and remanded the action to the District Court for further proceedings not inconsistent with its Opinion (Pet., p. 39).

The Court of Appeals found that the District Court had correctly decided that plaintiff had complied with the procedural requirements of FRCP 23(b) and concluded that a rule under which a demand upon the majority stockholders is a condition that cannot be excused in a case such as this is the type of hurdle that the Investment Company Act of 1940 forbids (Pet., p. 39).

Reasons Why the Writ Should Not Be Granted

The Petition does not present "special and important reasons" why this Court should exercise its discretionary power of review. While the questions have significance for the parties, they involve no "principles the settlement of which is of importance to the public, as distinguished from that of the parties" (*Layne & Bowler Corporation* v. *Western Well Works*, 261 U. S. 387, 393 (1923)).

The Petitioners have formulated four questions which they suggest are presented by the record in this case and ought to be reviewed by this Court. We respectfully submit, as we shall show later, that none of the questions presented by the Petitioners are appropriate for review. The only issue decided was one of pleading, and we suggest that we have stated it correctly in our formulation of the question presented (see p. 2, *supra*).

1. The first question formulated and presented by the Petitioners is premised upon an assumption that the law of the Commonwealth of Massachusetts requires a demand upon the body of stockholders before a derivative action may be maintained.

The Court of Appeals in its opinion (Pet., pp. 35-37) concluded that it was not satisfied that the Massachusetts law would require such a demand. The Court of Appeals had before it, fully cited and discussed by the Petitioners in their brief below, all of the Massachusetts cases claimed by them to be pertinent on this question, including the very recent case of *Datz* v. *Keller*, Mass. Adv. Sh. (1964) 491 (see Appellees' brief below, p. 18).

This Court, as a settled practice, places much reliance upon announcements by Courts of Appeals as to the law of the states within their respective circuits. In its opinion in *Spiegel's Estate* v. *Commissioner of Internal Revenue*, 335, U. S. 701 (1949), this Court said (at p. 708), in an opinion by Mr. Justice Black:

> "It is sufficient for us to say that we think reasonable arguments can be made based on Illinois cases to support a determination of this question either for or against the petitioner's contention. Under these circumstances we will follow our general policy and leave undisturbed this Court of Appeals holding on a question of state law" (citing in footnote (3) *Helvering* v. *Stuart*, 317 U. S. 154, 162-165, cf. *Steele* v. *General Mills*, 329 U. S. 433).

Thus, even where there may be a reasonable difference of opinion as to the law of the state, this Court has pursued the policy of leaving undisturbed the Court of Appeals holding on a question of state law.

The Court of Appeals here sustained the sufficiency of the complaint upon the ground that this was a federal cause of action, based upon violations of a federal statute and that the overriding federal law applicable determines the sufficiency of the allegations of the complaint, without regard to the provisions of the state corporation laws.

The Court of Appeals found support for its position in this Court's recent opinion in *J. I. Case Company* v. *Borak*, 84 S. Ct. 1555 (1964) (not yet officially reported).

We submit that this Court's views as expressed in that case enunciated guidelines which the Court of Appeals properly applied. The Petitioners seek to distinguish that case by an effort to narrow the principle there enunciated.

In *Borak, supra*, this Court broadly decided that it is the duty of the federal courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose in federal securities legislation. The sufficiency of a pleading to enforce a federal right should not be tested by a rule narrower in its application than the broad remedies which this Court declares it "is not uncommon for federal courts to fashion * * * where federal rights are concerned." No greater limitation should be attached to the rule of pleading than to the "appropriateness of redress."

The District Court cited in support of its conclusion this Court's decisions in *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U. S. 261 (1917), and *Price* v. *Gurney*, 324 U. S. 100 (1945). The Court of Appeals rejected these cases as distinguishable (see Opinion, Pet., p. 39, footnote 5). In their Petition in this Court, the

Petitioners again urge these cases as cogent authority for their contentions.

The *United Copper Securities Co.* case, *supra*, was a derivative action brought by stockholders of United Copper Securities Co. alleging that certain individuals and corporations had by conduct in violation of the Sherman Act injured United Copper Securities Company. It was an action at law. Neither the directors of United Copper Securities Company nor the company itself were alleged to have participated in the violations. The complaint alleged that demand had been made upon the corporation to bring the action but it had been rejected. There was no allegation that the United Copper Securities Company was controlled by the alleged wrongdoers or that the directors were guilty of any misconduct whatsoever. No application was made to the stockholders as a body; nor did it appear from the complaint that there were any special facts shown which rendered such application unnecessary. The District Court dismissed the complaint and the Court of Appeals affirmed. This Court affirmed the judgment of dismissal on the principal ground that the stockholders in seeking the aid of the court to enforce rights of their corporation could not pursue their remedy in an action at law. This was the main thrust of the decision. In addition, this Court held that the complaint was insufficient because it failed to plead in accordance with the rules which this Court enunciated in *Hawes* v. *Oakland*, 104 U. S. 450 (1882).

In quoting from *Price* v. *Gurney*, *supra*, the Petitioners omit reference to a significant portion of the opinion of Mr. Justice Douglas, in which he states (at p. 105):

> "There is a misconception running through the presentation of this case which should be noted at the outset. It is a misnomer to speak of the filing of the petition on behalf of the corporation as a

> derivative action. A derivative action is a suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party to the suit. And the relief which is granted is a judgment against a third person in favor of the corporation. * * * the petition which they have filed with the bankruptcy court is not a suit to enforce or protect a corporate right. Nor is it a suit to protect the interests of respondents as stockholders. * * * ''

In view of the foregoing, it can hardly be cited as cogent authority supporting the position of the Petitioners in a derivative action.

2. The second question which the Petitioners suggest is presented by the decision below deals with the propriety of the finding by the District Judge, affirmed by the Court of Appeals, that the complaint complies with the requirements of FRCP Rule 23(b). It should be noted that the Petitioners did not appeal from so much of the judgment in the District Court as denied their motions to dismiss the complaint because it did not comply with the requirements of FRCP Rule 23(b) (R., p. 18, para. 2; p. 19, para. 3; p. 20, para. 2). Having failed to enter such an appeal, the Petitioners ought not to be allowed to raise the question for review for the first time in this Court.

But even on the merits of their argument the Petitioners do not make out a case for review.

The main ground upon which the Petitioners seek review on this point is that the decision below is in conflict with *Haffer* v. *Voit*, 219 F. 2d 704 (6 Cir. 1955) (cert. den'd sub nom. *Ames* v. *Mengel Company*, 350 U. S. 832).

It is also suggested (Pet., p. 11) that this presents a decision on an important question of federal law "which has not been, but should be, settled by this Court."

The Petitioners are in error on both grounds urged.

This Court has long since established guidelines by which to test the sufficiency of the allegations of a complaint in a derivative action. After setting down the pleading requirements in the leading case of *Hawes* v. *Oakland, supra*, this Court adopted Equity Rule 94, which was followed by Equity Rule 27 and is now embodied in FRCP 23(b). In *Delaware & H. Co.* v. *Albany & S. R. Co.*, 213 U. S. 435 (1909), this Court declared that the rule "is intended to have practical operation, and to have that it must, as to its requirements, be given such play as to fit the conditions of different cases." Professor Moore seems to have come to the conclusion that "probably the most straightforward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand" (*3 Moore's Federal Practice, 2d Ed.*, Para. 23.19, p. 3525). The District Court cases which Professor Moore cites, relying upon this Court's decision in the *Delaware & Hudson Co.* case, came to the conclusion that it is within the power of the court to decide in every instance upon the facts pleaded as to whether or not a request to secure the action desired would have been an idle ceremony. Judge Leibell in *Cohen* v. *Industrial Finance Corporation*, 44 F. Supp. 491, 494 (S.D.N.Y. 1942), relying upon the *Delaware & Hudson Co.* case, said as follows:

> "Each case should be considered upon its peculiar facts and any arbitrary construction of the Rule, which would result in the emasculation of the equitable considerations that led to its enactment, should be avoided."

Pursuing this view to its logical conclusion, Judge Leibell continued (at p. 495):

> "Whether or not a demand is excused in a particular case is a question for the court [citing cases].

> In passing upon that question the court should consider the whole complaint, not merely the paragraph in which the pleader summarizes the reasons for not demanding action by the directors or stockholders."

A like application of the rule has recently been reflected in the opinion of the Court of Appeals for the Fourth Circuit in *Meltzer* v. *Atlantic Research Corporation*, 330 F. 2d 946 (1964). Judge Bryan cited this Court's decision in the *Delaware & Hudson Co.* case as authority for the sufficiency of a somewhat similar allegation of futility of demand upon the shareholders (at p. 949).

Based upon the *Delaware & Hudson Co.* case, the prevailing view is that in each instance the court of original jurisdiction must satisfy itself upon the facts pleaded in the particular case whether or not a demand is necessary. The Court of Appeals in the instant case took this view in its opinion (Pet., pp. 34, 35) in affirming the correctness of the decision of the District Court that the plaintiff had complied with the procedural requirements of FRCP 23(b).

Thus, there is no conflict in the application of principle of law which this Court is called upon to resolve.

In each of the cases discussed, the court considered the peculiar facts pleaded and came to the conclusion appropriate to the particular case. These differences in appraising the facts pleaded do not constitute "a real and embarrassing conflict of opinion and authority between the Circuit Courts of Appeals" (*Layne & Bowler Corporation* v. *Western Well Works*, 261 U. S. 387, 393 (1923)). This Court has dismissed a Writ of Certiorari as improvidently granted when it appeared that the asserted conflict in decisions arose "from differences in states of fact, and not in the application of a principle of law" (*Wisconsin Electric Company* v. *Dumore Company*, 282 U. S. 813 (1931)).

3. The questions which the Petitioners have suggested in formulations 3 and 4 of the questions presented (Pet., p. 2) are not ripe for decision at this time. They were presented to, and argued in, the Court of Appeals (Pet., p. 5, Appellees' Brief, pp. 44-47 as to question 3; pp. 47-55 as to question 4). That Court declined to consider or decide them (Pet., App. B, p. 33).

This Court has long since pursued the policy of declining to review questions not passed upon below, except in exceptional cases.

In *United States* v. *Fleischman*, 339 U. S. 349, 365 (1950), the Chief Justice, writing for this Court, said: "Respondent advances a number of contentions which were not passed upon by the Court of Appeals. We do not decide them at this time." See also *Larson* v. *Domestic & Foreign Commerce Corporation, supra* (at p. 685); *Owens* v. *Union Pac. R. Co.*, 319 U. S. 715, 724 (1943); *Duignan* v. *United States*, 274 U. S. 195, 200 (1927).

The Petitioners have not made a showing that this is such an exceptional case as to warrant departure from the established rule.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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October, 1964.

APPENDIX A

Statute Involved

INVESTMENT COMPANY ACT OF 1940

Act of August 22, 1940, Chapter 686, Title I, 54 Stat. 789 (15 U.S.C. § 80a-1 *et seq.*).

FINDINGS AND DECLARATION OF POLICY

SEC. 1. [15 U.S.C. § 80a-1.] * * *

* * *

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public —interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other invest-

ment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasi-

ble, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

General Definitions

Sec. 2. [15 U.S.C. § 80a-2.] (a) When used in this title, unless the context otherwise requires—

* * *

(2) "Affiliated company" means a company which is an affiliated person.

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

* * *

(28) "Principal underwriter" of or for any investment company other than a closed-end company, or of any security issued by such a company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right

(whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company. "Principal underwriter" of or for a closed-end company or any issuer which is not an investment company, or of any security issued by such a company or issuer, means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

* * *

AFFILIATIONS OF DIRECTORS

SEC. 10. [15 U.S.C. § 80a-10.] (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(b) After one year from the effective date of this title, no registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board

of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or affiliated persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 12(d)(3)(A) and (B).

* * *

LARCENY AND EMBEZZLEMENT

SEC. 37. [15 U.S.C. § 80a-36.] Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the monies, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

* * *

JURISDICTION OF OFFENSES AND SUITS

SEC. 44. [15 U.S.C. § 80a-43.] The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, his title or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended, and section 7, as amended, of the Act entitled "An Act to establish a court of appeals for the District of Columbia", approved February 9, 1893. No costs shall be assessed for or against the commission in any proceeding under this title brought by or against the Commission in any court.

VALIDITY OF CONTRACTS

SEC. 47 [15 U. S. C. § 80-a-46] (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void.

(b) Every contract made in violation of any provision of this title or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order.